

***United States Court of Appeals
for the Second Circuit***



**BRIEF FOR
APPELLANT**

76-4170

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

DOCKET NO. 76-4170

EDWARD M. GILBERT,

Appellant,

- against -

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

ON APPEAL FROM THE UNITED STATES
TAX COURT

BRIEF ON BEHALF OF APPELLANT

CURTIS, MALLET-PREVOST,
COLT & MOSLE
ATTORNEYS FOR APPELLANT
100 Wall Street
New York, New York 10005

Of Counsel:

PETER E. FLEMING JR.
JOHN E. SPRIZZO
ROBERT D. WHORISKEY
JAMES M. BOYD

B
P/S

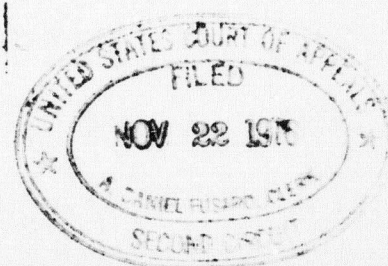


TABLE OF CONTENTS

	<u>Page</u>
PRELIMINARY STATEMENT.....	1
QUESTION PRESENTED.....	2
STATEMENT OF FACTS.....	2
POINT I - Gilbert did not realize taxable income for the taxable year 1962 as a result of his unauthorized withdrawals from Bruce.....	10
POINT II The Internal Revenue Service prevented Gilbert from making a repayment in 1962 of the funds withdrawn from Bruce.....	23
CONCLUSION.....	30

CITATIONS

	<u>Page</u>
Cases:	
<u>Buff v. Commissioner</u> , 496 F.2d 847 (2d Cir. 1974).....	19 thru 22
<u>Glass City Bank v. United States</u> , 326 U.S. 265 (1945).....	25
<u>Helvering v. Price</u> , 309 U.S. 409 (1940).....	24
<u>James v. United States</u> , 366 U.S. 213 (1961).....	2, 10, 11, 18 thru 23
<u>Mais, Norman</u> , 51 T.C. 494 (1968).....	19, 21, 22
<u>Merrill, United States v.</u> , 211 F.2d 297 (9th Cir. 1954).....	19, 20
<u>Robinson, Ray S.</u> , 44 T.C. 20 (1965).....	29
<u>Wilcox, Commissioner v.</u> , 327 U.S. 404 (1946).....	10
Rulings:	
Rev. Rul. 65-254, 1965-2 C.B. 50.....	23

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

- - - - -X

EDWARD M. GILBERT, :

Appellant, :

- against - :

Docket No. 76-4170

COMMISSIONER OF INTERNAL REVENUE, :

Appellee. :

- - - - -X

APPELLANT'S BRIEF

Preliminary Statement

The findings of fact and opinion of the Tax Court are by memorandum decision, T.C. Memo. 1976-104, unofficially reported at 35 T.C.M. 451 (1976) (R. 187a)*. The opinion is by the Trial Judge, Hon. William H. Quealy.

The case involves a deficiency in federal income tax determined against the taxpayer, Edward M. Gilbert (hereinafter "Gilbert"), for the taxable year 1962 in the amount of \$1,467,536.51. The deficiency is based on withdrawals from E.L. Bruce Co., Inc., (hereinafter "Bruce"), in the net sum of \$1,953,000.00. The funds were used to meet Gilbert's

*"R" references are to the separately bound record appendix.

personal margin calls on Celotex Corporation (hereinafter "Celotex") stock. Celotex was the target for a proposed merger with Bruce. Pursuant to the proposed merger, stock of Celotex was being acquired by Bruce, Gilbert and other parties in favor of the proposed merger.

The Tax Court decided that Gilbert realized income in the amount of \$1,953,000.00 as a result of the withdrawals. Its opinion was based on the doctrine of James v. United States, 366 U.S. 213 (1961). This appeal is taken from the decision below.

QUESTIONS PRESENTED

1. Whether Gilbert realized taxable income during 1962 under the doctrine of the James case?
2. Assuming arguendo that there was income realized by Gilbert in 1962, whether government action prevented a deductible repayment in full by the taxpayer to Bruce in 1962?

STATEMENT OF FACTS

Gilbert is a cash basis, calendar year taxpayer (Stip. Pars. 39, 2; R. 4a, 12a). He resided at 525 Park Avenue, New York, New York 10021 at the time of the filing of his petition to the Tax Court (Stip. Par. 1; R. 4a).

For the taxable year 1962 he filed a Federal income tax return with the District Director of Internal Revenue, New York, New York (Ex. 1-A; R. 53a).

From September, 1958 until June 12, 1962, Gilbert was first Chairman of the Executive Committee and later President, the principal executive officer and a director of Bruce and its predecessor corporations (Stip. Par. 3; R. 5a). During this period Gilbert was also the major stockholder of Bruce and a director and a principal executive officer of Rhodes Enterprises, Inc. (hereinafter "Rhodes"), all of whose issued and outstanding stock he beneficially owned. Gilbert also beneficially owned and controlled the Empire Hardwood Flooring Corporation (Stip. Par. 4; R. 5a).

In 1961 and 1962 Gilbert personally and through Rhodes undertook the purchase of a large number of shares of Celotex. All such stock acquired by Gilbert and Rhodes was purchased on margin. Gilbert pledged all of his stock of Bruce as collateral for loans to purchase the Celotex stock (Op. 4; R. 190a).

In addition to the shares purchased by Gilbert and Rhodes, Bruce also purchased substantial amounts of Celotex shares (Stip. Par. 10; R. 6a). By the end of May, 1962, Bruce had approximately 100,000 Celotex shares, worth approximately \$36 a share, or \$3,600,000 total (Tr. 56; R. 23a).

The purpose for acquiring the Celotex stock was to accomplish a merger between Bruce and Celotex (Op. 5, 6; R. 191a). On March 5, 1962, Gilbert granted to Bruce an option to purchase these Celotex shares at his cost (Stip. Par. 9; R. 6a).

Gilbert also induced friends and associates of his to purchase Celotex stock, guaranteeing them against loss. By the end of May, 1962, approximately 56% of the outstanding stock of Celotex was controlled by Bruce, Gilbert and his associates and available for the proposed merger. Negotiations for the merger had proceeded to the point in late May where it was agreed that certain directors of Bruce would be placed on the Board of Celotex (Op. 7; R. 193a).

In late April, 1962, Gilbert went to Nevada to establish a residence in order to obtain a divorce (Op. 7; R. 193a). During the latter part of May, 1962, the stock market began to decline and then declined severely on May 28, 1962. While still in Nevada, Gilbert was called upon to furnish additional margin for the Celotex stock purchased by him and his associates (Op. 7; R. 193a).

Gilbert did not have sufficient liquid assets to meet the margin call (Stip. Par. 13; R. 6a). He contacted Bruce's secretary, Irwin Polivy, and found that Bruce had

sufficient liquid assets to meet the margin calls. Gilbert instructed Mr. Polivy in substance to meet the margin calls (Tr. 60, 61; Stip. Par. 14; R. 26a, 27a; R. 7a). This was done by issuing a series of checks drawn on the account of Bruce, payable to either Rhodes or to Empire Hardwood Flooring Corporation, totaling \$1,958,000 (Ex. 16-P; R. 130a). On June 5, 1962, Empire Hardwood Flooring Corporation repaid \$5,000 of this amount (Op. 7, 8; R. 193a, 194a).

There is no dispute but that the contemplated merger would have been in Bruce's best interests. The product lines of the two companies complemented one another. The combination of their sales organizations would have avoided substantial duplication of effort, resulting in large savings. Celotex was highly liquid, and the book value of its assets was substantially below actual value. The Bruce board, as well as Gilbert, favored the merger with Celotex (Tr. 103-105; R. 37a-39a).

Both during and following the withdrawal of Bruce funds, Gilbert at no time attempted to conceal from Bruce either the fact of the withdrawals or the amounts involved. He promptly informed counsel for Bruce and various of the directors of Bruce regarding the facts and circumstances of the withdrawals, together with his intent to repay the same (Tr. 62, 63, 66; R. 28a, 29a, 32a).

On June 8, 1962, Gilbert went to the offices of Sherman (sic), Sterling and Wright, who were outside counsel for Bruce at the time. Mr. Robert N. West, a partner in the firm, prepared promissory notes in the aggregate amount of the withdrawals, together with an assignment to Bruce of all of Gilbert's property, real and personal (Op. 8; R. 194a).

The notes were predated by Mr. West to coincide with the dates of the withdrawals. The assignment also was predated to May 28, 1962. The notes and the assignment were executed on June 8, 1962 (Op. 8, Tr. 35-37; R. 194a, R. 17a-19a).

The Court below found that the fair market value of the cash, securities and other property assigned by Gilbert to Bruce on June 8, 1962, to secure the promissory notes of Gilbert aggregating \$1,953,000 substantially exceeded the face amount of said notes on June 8, 1962, and on June 12, 1962 (Op. 9; R. 195a).

During this period, Gilbert also initiated negotiations to sell the stock of Celotex held by Bruce, Rhodes and himself to the Ruberoid Company. A meeting of the Board of Directors of Ruberoid Company was called to be held on June 12, 1962, in order to consider such proposal (Op. 8; R. 194a).

On June 11, 1962, Gilbert had met with four of the Bruce directors and had informed them fully of the unauthorized withdrawals, the purpose of the withdrawals, and of the arrangement which he had made to repay the withdrawn amounts to Bruce (Tr. 66; Ex. 23-W, pp. 12-16; R. 32a; R. 157a-161a).

A special meeting of the Board of Directors of Bruce was held on the next day, June 12, 1962. Mr. Robert N. West informed the Board of Directors that Gilbert had caused a series of withdrawals from Bruce in the total amount of \$1,953,000, describing the circumstances leading up to the withdrawals and the manner in which they were made. Mr. West also reported the negotiations with Ruberoid Company for the sale of the Celotex stock at a price of \$36 per share (Op. 9; R. 195a). However, he also reported that the proposed sale at this price had been rejected (Ex. 5-E, p. 4; R. 85a). Negotiations continued for the sale of the Celotex stock; and it was not until that evening that it was learned there would be no sale. (Ex. 23-W, p. 35; Tr. 67; R. 177a; R. 33a).

After a prolonged meeting, the Board of Directors requested and received on June 12, 1962 the resignations of Gilbert as a director and president of Bruce and the resignation of Erwin Polivy as secretary of Bruce (Op. 9; R. 195a).

Gilbert departed for Brazil on the evening of June 12, 1962 (Stip. Par. 37; R. 12a). There followed a sharp decline in the market price of the stock of Bruce. The stock of Celotex was similarly affected (Ex. 20-T; R. 145a).

On June 13 or June 14, 1962, Bruce attempted to file Gilbert's assignment. Bruce was informed by the County Clerks office that there would be a filing fee of between \$10,000 and \$15,000 for the mortgage recording tax because real estate was included in the assignment. Bruce chose not to pay the filing fee, and, accordingly, failed to file the assignment at that time (Op. 12; R. 198a).

Notices of Federal tax liens in the sum of \$3,341,743.95 were filed on June 22, 1962 with respect to the income tax liabilities of Gilbert and his wife, Rhoda Gilbert, for the taxable years 1958, 1959, 1960 and 1962 (Supp. Stip. Par. 44; R. 14a). The above liens were filed with respect to joint jeopardy assessments of income taxes made against Edward and Rhoda Gilbert for the taxable years 1958, 1959 and 1960 in the respective amounts of \$3,836.40, \$1,119,164.80 and \$494,986.20. The 1958 assessment has been paid in full. The 1959 and 1960 deficiencies and penalty, determined by the Tax Court in the respective amounts of \$76,598.58 and \$18,071.13, have been paid in full. Also, a joint assessment was made June 22, 1962, in the amount of \$1,723,776 (Supp. Stip. Pars. 45-48; R. 15a).

During the first week of November, 1962, Gilbert returned from Brazil to New York (Stip. Par. 37; R. 12a). On November 5, 1962, at the request of Bruce, Gilbert executed a second assignment in favor of Bruce, this time omitting real property (Tr. 52; R. 21a). On November 27, 1962, a consent judgment in favor of Bruce in the amount of \$1,953,000 plus interest was entered against Gilbert (Op. 13; R. 199a).

On June 28, 1962, a fifteen count indictment was filed against Gilbert in the United States District Court for the Southern District of New York relating to the misappropriation of corporate funds of Bruce and violations of the securities laws (Stip. Par. 28; R. 9a). On September 25, 1964, Gilbert entered a plea of guilty to counts one, five and seven (Stip. Par. 29; R. 9a).

On February 2, 1967, pursuant to an indictment for grand larceny, filed against Gilbert on July 9, 1962, by a New York County grand jury, Gilbert entered a plea of guilty to counts, five, six and ten (Stip. Pars. 30, 31; R. 9a).

For the fiscal year ended June 30, 1962, Bruce claimed a loss deduction on its books and records which included the withdrawals caused by Gilbert of \$1,953,000 (Stip. Par. 42; R. 12a).

POINT I

GILBERT DID NOT REALIZE TAXABLE
INCOME FOR THE TAXABLE YEAR 1962
AS A RESULT OF HIS UNAUTHORIZED
WITHDRAWALS FROM BRUCE

The Court below held that Gilbert wrongfully diverted to his own use the net amount of \$1,953,000 in Bruce funds, during the period beginning on May 28, 1962 and ending on June 7, 1962. Citing James v. United States, supra, the Court below held that Gilbert was chargeable with having realized income to the extent of his unauthorized withdrawals of funds from Bruce. The James case overturned an earlier decision of the United States Supreme Court in Commissioner v. Wilcox, 327 U.S. 404 (1946) which held that embezzled funds did not constitute taxable income to the embezzler in the year of the embezzlement. In James, the Court stated a rule of application to all cases involving wrongful or unauthorized withdrawals of funds, to wit:

When a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition, "he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." North American Oil v. Burnet, supra, 366 U.S. at 219.

It is Gilbert's contention in this appeal that he did not realize embezzlement income within the meaning of the James case as found by the Court below. Specifically, Gilbert contends that the wrongful withdrawal of Bruce funds by him meant that he ". . . unlawfully . . ." acquired property in 1962, but that the unauthorized withdrawal and use of Bruce funds by him was not ". . . without the consensual recognition, express or implied, of an obligation to repay . . ." within the meaning of the James case.

The misappropriation of corporate funds by Gilbert arose out of his efforts to cause a corporate combination of Bruce and Celotex. At a regular meeting of the Board of Directors of Bruce on January 8, 1962, Gilbert submitted a statement to the Board indicating his belief that if a substantial amount of Celotex stock were held in friendly hands it might be possible at some future date to offer Bruce stock, securities and cash in exchange for the outstanding Celotex shares. At that time, Gilbert refrained from recommending an acquisition of Celotex by Bruce but did offer to Bruce 50,000 shares of Celotex stock held by him individually at his cost (Ex. 2-B, statement; R. 74a). At that meeting, the Board of Bruce did not accept Gilbert's offer to purchase his Celotex shares (Ex. 2-B, p. 1; R. 73a).

On March 5, 1962 at a regular meeting of the Bruce Board, Gilbert read a further statement indicating that although he had disposed of his Celotex shares, he expected to purchase additional shares and he reiterated his offer to make any such shares available to Bruce at his cost. He again recommended the combination of Bruce and Celotex. He also indicated his belief that approximately 400,000 shares of Celotex out of a total of 1,028,651 shares outstanding were in the hands of persons who would favor a combination of Celotex with Bruce. Pursuant to his recommendation, the Board of Bruce authorized Bruce to purchase up to \$400,000 of Celotex stock, further authorized Bruce to consult with the investment banking firms of Lazard Freres & Co. and Carl M. Loeb Rhoades & Co., to obtain their recommendations as to the financial basis on which a combination of Bruce and Celotex could be effected, and further authorized Bruce officers to consult with the management of Celotex about a merger (Ex. 3-C; R. 75a).

On April 17, 1962, Gilbert recommended and the Board authorized the purchase by Bruce of more Celotex shares with an additional \$1,000,000 in existing funds, plus the proceeds from the liquidation of noncurrent assets, as well as the proceeds received from an increase in a loan with Connecticut Mutual Life Insurance Company to the extent of \$1,800,000 (Ex. 4-D; R. 80a).

While Gilbert and his wholly owned corporation, Rhodes Enterprises, Inc., purchased Celotex stock on margin, Bruce itself purchased substantial amounts of Celotex stock. Gilbert also induced his friends and associates to purchase Celotex shares, guaranteeing them against loss. At the end of May, 1962, Bruce, Gilbert, and his associates controlled 56% of the outstanding Celotex shares. Negotiations for the merger proceeded in late May to the point where agreement was reached that certain directors of Bruce would be placed on the Board of Celotex.

Gilbert left New York in late April of 1962, to go to Nevada in order to obtain a divorce. During the latter part of May, 1962 while he was still in Nevada, there was a severe decline in price of both Celotex and Bruce shares. When Gilbert was called to furnish additional margin, he lacked liquid funds to do so and the unauthorized withdrawals of Bruce funds in the amount of \$1,958,000 followed.* On June 8, 1962 Gilbert met with Bruce's outside counsel, having previously disclosed the withdrawals to them. Outside counsel prepared promissory notes for Gilbert to execute in the amount of \$1,953,000, together with an assignment to Bruce of all of Gilbert's property, both real and personal.

*There was a \$5,000 repayment on June 5, 1962.

The promissory notes, as executed by Gilbert, were predated by outside counsel to Bruce to coincide with the dates of each of the unauthorized withdrawals. The assignment, although executed on June 8, 1962, was also predated to May 28, 1962, and was executed by Gilbert.

The Court below found that, "The fair market value of the cash, securities and other property assigned by . . . [Gilbert] . . . on June 8, 1962, to secure the promissory notes aggregating \$1,953,000 substantially exceeded the face amount of said notes on June 8, 1962 and on June 12, 1962." (Op. 9; R. 195a).

Thomas H. Creech, a Vice President and Director of Bruce testified in a deposition given in 1965, that he and three other Bruce Directors met with Gilbert and others on June 11, 1962. At that time, a full disclosure was made by Gilbert to those directors to the effect that Gilbert had wrongfully withdrawn \$1,953,000 in Bruce funds to cover margin calls on Celotex stock (Ex. 23-W, p. 13; R. 158a). Gilbert on that occasion told those Board members that the unauthorized withdrawals were used in the best interests of Bruce. Mr. Creech said that Mr. Gilbert at that time contended to Mr. Creech and the others ". . . that what he had done in connection with acquiring Celotex stock was for the long range advantage of E.L. Bruce & Co. and that he had

taken this money and certainly he had not gone through the proper channels, and it was definitely admitted that this was unauthorized but that since it was in the best interest of the corporation and since he was going to make full restitution, which he had agreed to, that it was hoped that we could find some way in the board meeting the next day to ratify these actions (emphasis added)" (Ex. 23-W, p. 14; R. 159a).

According to Mr. Creech, Gilbert on that occasion said ". . . that he had certainly taken the money and he realized that he was wrong, he had not gotten authorization on it but that he was going to pay every penny back and that he already made arrangements for doing so . . . He mentioned the fact that he had already assigned all of his assets to the company. I think he went into a description of the value of some of these things, such as the paintings and the stamp collection. And he was telling about how much money they were worth and that this would undoubtedly take care of the full amount of his debt." (Ex. 23-W, p. 16; R. 161a).

On the following day, June 12, 1962, the full Board of Bruce met to consider Gilbert's use of Bruce funds. Quoting the discussions of the Board on that occasion, Mr. Creech stated that ". . . the representation was made by Mr. Gilbert that if this Ruberoid deal went through and some

of these other assets that he had assigned to us could be sold promptly, that this would pay back all of this money that he had taken from the company." (Ex. 23-W, p. 27; R. 170a). Mr. Creech stated that, "There was a discussion of the Celotex stock which Edward Gilbert owned being purchased by the Ruberoid Corporation, and we felt, from (sic) much of the morning, that this would be accomplished, until we heard from the Ruberoid -- got a message from the Ruberoid people, who were also in session at a board meeting, that the proposal that they purchase the Celotex stock had been turned down." (Ex. 23-W, p. 26; R. 169a).

When the proposed purchase by Ruberoid of the Celotex shares owned by Gilbert was no longer possible, the Bruce Board requested and obtained Mr. Gilbert's resignation as president and director of Bruce. Shaken by his losses and by the failure of the Bruce Board to ratify his use of Bruce funds, Gilbert lost his perspective and fled that night to Brazil.

It is ironic in a sense that Gilbert's success in persuading the Bruce Board to acquire Celotex shares, in order to acquire Celotex, led to such disastrous consequences for himself. He had not only given guarantees to his associates, who were purchasing Celotex at his recommendation, but he had also purchased a substantial number of

Celotex shares on margin, involving himself in a major financial commitment. At the same time, he had made a continuing offer to Bruce, permitting Bruce to purchase all of the Celotex shares owned by Gilbert at his cost. When the market dropped precipitously, Gilbert realized, (although did not recognize for tax purposes), substantial economic losses in value for his Celotex and his Bruce shares. Of greater urgency, he was faced with immediate and substantial cash requirements to meet margin calls. Recognizing that he would be obliged to restore any unauthorized withdrawals of Bruce funds, Gilbert nevertheless proceeded to cover his margin calls. Bruce also was benefited by this in that this preserved the Celotex stock available for the merger. In addition, Gilbert was committed at all times to restore the unauthorized withdrawals of Bruce funds.

Thus there appears to be no dispute below that Gilbert at all times intended to repay the wrongfully withdrawn funds (Tr. 63; R. 29a). Within a few days of instructing the corporate secretary of Bruce to issue Bruce checks to him, Gilbert informed Bruce's outside counsel of the withdrawals (Tr. 62; R. 28a). He then proceeded to promptly notify various other directors (Tr. 66; Ex. 23-W, p. 13; R. 32a; R. 158a). When a meeting was called of the Bruce Board on June 12, 1962, although the Board refused

to sanction his actions, Gilbert again indicated his intentions to make prompt restitution of the funds. His promissory notes, and assignment predated to May 28, 1962, the date of the first withdrawal, were called to the attention of the Board. Although he also attempted on that same day to sell his Celotex stock to Ruberoid Corporation to repay the withdrawals from Bruce, that effort was unsuccessful (Tr. 65; R. 31a).

Therefore, the unauthorized withdrawals by Gilbert were not conducted surreptitiously in order to deceive Bruce, but, rather were made in furtherance of a corporate plan of action initiated by Gilbert and endorsed by the Board in which he had made a personal financial commitment of a substantial nature. Whether or not the Bruce Board approved of Gilbert's withdrawals, there was a clear recognition by Gilbert and Bruce of Gilbert's obligation to restore the funds. It is respectfully submitted that there could not be a clearer case for application of the rule enunciated in the James decision that the unlawful withdrawal of funds by Gilbert was with express consensual recognition of his obligation to repay the misappropriated funds. Appellant urges the Court to reverse the decision below as an improper implementation of the very clear language of the James decision.

There are cases where a taxpayer concealed his embezzlement from his employer, and only after its discovery made arrangements for restitution. Buff v. Commissioner, 496 F.2d 847 (2d Cir. 1974), rev'g., 58 T.C. 224 (1972); Norman Mais, 51 T.C. 494 (1968). The Court below expressly declined to follow its decision in the Buff case, because of this Court's reversal on appeal of the Tax Court decision in that case.* The Mais case interestingly was relied upon by the dissenting opinion in the Tax Court in the Buff case.

In the Buff case, the taxpayer covertly embezzled approximately \$22,000 from his employer between January 1, and June 7, 1965. When the embezzlement was discovered by his employer in June of 1965, the taxpayer executed at his employer's insistence an affidavit of confession of judgment for the embezzled funds, plus interest, and agreed to continue his employment and repay \$25 per week from his paycheck. He also paid \$1,000 to his employer from the proceeds of a loan. In July of 1965 the employer became dissatisfied with the arrangement, discharged the taxpayer, and filed the confession of judgment. Relying in part on United States v. Merrill, 211 F.2d 297 (9th Cir. 1954), the Tax Court held that there was a consensual recognition of an obligation to repay within the meaning of the James case and that, consequently, the taxpayer Buff had realized no income in that

*The opinion of the Court below indicates that Gilbert relied upon the Buff case. He did not. Rather, Gilbert distinguished the Buff case in the arguments presented below from the circumstances of this case.

year. This Court reversed the Tax Court in the Buff case, finding Merrill to be distinguishable. (A concurring opinion held Merrill to be "erroneously decided.") This Court also followed the dissenting opinion of Judge Hoyt in the Tax Court* and found that "the judgment was not worth the paper

*In reversing Buff, this court in its Opinion indicated that the seven dissenting judges in the Tax Court and the brief filed by the Commissioner with this court raised three arguments for reversal of the Buff case. The first argument in substance was that it was improper as a matter of tax accounting to permit a cash-basis taxpayer to offset for tax purposes the receipt of income with a promise not given "in connection with the receipt" of income to repay the misappropriated funds in a subsequent taxable year. 496 F.2d 848. The second argument was that "the lack of consensual recognition of an obligation to repay at the time of receipt is the crucial element to consider for purposes of James v. United States, supra, rather than the presence of that recognition at the end of the pertinent accounting period. James which . . . held embezzled funds to be income, distinguished embezzlement from a loan arrangement by stating that, although the embezzler had an obligation in law to repay the misappropriated funds, he lacks the consensual recognition of this obligation. 366 U.S. at 219-220. James, however, is silent as to the precise moment a court should inquire as to the presence or absence of this recognition." 496 F.2d 848. The third argument was that the confession of judgment, executed by the taxpayer in the Buff case, should be viewed as a mere shame and, as such, be given no tax significance. 496 F.2d 848. By contrast, the facts of the instant case appear to meet each of the three arguments cited by this court in Buff. Specifically, with regard to the first argument noted above, Gilbert executed promissory notes and assigned all of his assets to Bruce in connection with the withdrawal of Bruce funds by him to cover his margin calls. With respect to the second argument, Gilbert's "consensual recognition" to repay Bruce for Gilbert's unauthorized withdrawals of Bruce funds occurred during the period of the withdrawals and was evidenced by Gilbert's execution of predated promissory notes and a predated assignment of assets on the day following that period. As to the third argument, the court below found that the value of the assets assigned by Gilbert to Bruce substantially exceeded the amount of the promissory notes executed by him and thus no sham was involved.

it was written on . . ." 496 F.2d at 849. This Court further found in Buff that to allow a confession of judgment to offset \$22,000 wrongfully taken in cash "would be wholly unrealistic." 496 F.2d at 849.

Gilbert therefore, believes that the Buff case has no revelence to the instant case, but that if the arguments cited by this Court in Buff (see footnote on Page 20) supporting a reversal in that case are to be applied to the instant case that a reversal in this case should follow as matter of course.

In Norman Mais, supra, the taxpayer had embezzled funds. When the embezzlement was discovered in the same year, he acknowledged his obligation to make restitution. The Tax Court held that the acknowledgement of an obligation to repay in those circumstances could not be considered to be a consensual recognition within the meaning of the James case. The Court stated that:

"We interpret the James case as meaning that any taxpayer who acquires property under circumstances which do not permit the conclusion that the property was received with a consensual

recognition, express or implied, of an obligation to repay, and without restriction as to its disposition, is in receipt of taxable income. Certainly in the case of embezzlement it cannot be considered that the funds are obtained by the embezzler under any consensual recognition of an obligation to repay; indeed, the victim of the embezzlement is unaware of the diversion of his property." 51 T.C. at 498.

Appellant contends that the Court below has misapplied the concept of consensual recognition in the Mais case, in the Buff case, and in the instant case. From the plain language of James, the issue of consensual recognition at the very least is approached from the point of view of the taxpayer and his employer who together recognize an unauthorized appropriation of funds by the taxpayer and promptly make a realistic arrangement for repayment. Arguably, James may also be approached solely from the viewpoint of the taxpayer and not from that of the victim, although Gilbert believes that there is no need to take that position in the circumstances of this case. Clearly, the James case couples the notion of a wrongful misappropriation of funds with the concept of a consensual recognition to repay those funds but without explicitly indicating the circumstances under which such consensual recognition could arise. It is respectfully submitted that in this case, where the funds were connected with a corporate purpose and

the obligation to repay was recognized by both Bruce and Gilbert at the time of the withdrawals, it would seem to be a classic circumstance envisaged by the language of the James case where no taxable income should result for unauthorized withdrawal of corporate funds.

For these reasons it is respectfully submitted that the decision reached by the Court below should be reversed.

POINT II

THE INTERNAL REVENUE SERVICE PREVENTED GILBERT FROM MAKING A REPAYMENT IN 1962 OF THE FUNDS WITHDRAWN FROM BRUCE

If this Court affirms the decision below and holds that Gilbert realized income in 1962 because of the unauthorized withdrawals from Bruce, the question of repayment becomes especially important. A deduction is allowed for the repayment of illegal earnings which were initially included in income. James v. United States, supra; Rev. Rul. 65-254, 1965-2 C.B. 50. Thus, if such a repayment had occurred in 1962 to the full extent of the amount of the funds wrongfully withdrawn by Gilbert in that year, there would be a deduction for federal tax purposes offsetting the same amount of income.

Gilbert, a cash basis taxpayer, does not contend in this case that the mere tender of his secured notes should be considered to be payment in 1962 to the extent of the face amount of the notes. Helfring v. Price, 309 U.S. 409 (1940). Gilbert, however, did everything in his power to accomplish a full repayment in 1962. He attempted to sell his Celotex stock to provide the necessary funds to repay Bruce. He also made an assignment to Bruce of all of his assets, including cash in banks, on two separate occasions during 1962 (Exs. 9-I and 10-J; R. 105a, R. 110a). If the assigned assets could have been reduced either to the actual possession of Bruce or converted to cash by Bruce in 1962, Gilbert would have been in a position to have established that an actual payment had been made to Bruce by him in that year.

The Tax Court's Opinion correctly indicates that Bruce did not accept the assignment by Gilbert of all of his assets to Bruce in payment of the full amount of the claim in 1962 which Bruce had against Gilbert for the unauthorized withdrawals (Op. 16; R. 202a). Nevertheless, the record clearly indicates that Gilbert's notes and his assignment to Bruce were accepted by Bruce as a means of achieving payment of Gilbert's indebtedness to Bruce. It should be remembered that the notes and assignment were

executed at the instigation of Bruce's outside counsel. Further, Bruce attempted to register the assignment on June 13, or 14, 1962 (Tr. 109, 110; R. 109a, 110a). Because of the filing fee, the assignment was not filed, and thus was not perfected as a secured interest against third parties. When the Internal Revenue Service made jeopardy assessments against Gilbert in amounts in excess of the value of the assets assigned by Gilbert to Bruce and filed notices of federal tax liens, it claimed a prior right to such assets. Glass City Bank v. United States, 326 U.S. 265 (1945).

On June 22, 1962, notices of federal tax lien in the aggregate amount of \$3,341,743.95 were filed by the Internal Revenue Service covering the jeopardy assessments. The jeopardy assessment for 1958 was in the amount of \$3,836.40, all of which was paid. The jeopardy assessment for 1959 was in the amount of \$1,119,164.80. The jeopardy assessment for 1960 was in the amount of \$494,986.20. The actual income tax deficiencies of Gilbert for 1959 and 1960, as determined in a stipulated decision entered by the Tax Court, were in the respective amounts of \$76,598.58 and \$17,889.89, a fraction in each case of the original jeopardy assessments.* These amounts have been paid in full. The jeopardy assessments for 1962 in the amount of \$1,723,776 is the major liability which both

*There was also a delinquency penalty for the year 1960 in the amount of \$734.24 (Sup. Stip. Par. 47; R. 15a).

Bruce and Gilbert had to contend with and the merits of that jeopardy assessment, of course, are the subject of this appeal.

Although the Internal Revenue Service clearly did not cause Gilbert to realize income to the extent of his unauthorized withdrawals from Bruce in 1962, it did intervene at a point after which both the amount and the means by which restitution was to be effected had been agreed upon by both Gilbert and Bruce. By preventing Gilbert from repaying the unauthorized withdrawals, the government solely by its own act increased Gilbert's taxable income for 1962. Stated differently, only Gilbert, and not the government, could have caused the unauthorized withdrawals to have been included in his gross income for that year. But only the government, and not Gilbert, could have caused the intended repayments not to be paid and thus not to be deductible in the same year. After Gilbert had commenced the process of restitution, he could do nothing further to prevent repayment from occurring (although he could have assisted Bruce in accelerating liquidation of his assets in order to effect an earlier repayment). Since the government's act denied Gilbert the availability of a deduction to the extent of halting the process of restitution, the Internal Revenue

Service caused Gilbert to increase his taxable income.

The record below contains extensive testimony concerning the availability of Gilbert's assets to satisfy the full amount of the Bruce claim against Gilbert which was evidenced by the promissory notes. The tortured and prolonged history of the wasted efforts to reach agreement between Bruce and the government on the disposition of Gilbert's assets, secured by both the government's tax liens and Gilbert's assignment to Bruce, are documented in extensive detail in the record below. Without making a detailed finding of fact in this respect, the Court below concluded that the fair market value of the cash, securities and other property assigned by Gilbert on June 8, 1962, to Bruce to secure his promissory note aggregating \$1,953,000 "substantially exceeded the face amount of said notes on June 8, 1962, and on June 12, 1962" (Op. 9; R.195a). Had the government not made its jeopardy assessments against Gilbert in 1962, then Bruce during the more than six months remaining in that year could have liquidated Gilbert's assets and applied the cash in full payment on their claim against Gilbert. As a result, Gilbert would have realized no net embezzlement income in 1962 as determined in the statutory notice of deficiency issued by the Internal Revenue Service.

Because of the intervention of the Internal Revenue Service on June 22, 1962 through the jeopardy assessments, neither Bruce nor the Internal Revenue Service has realized more than a fraction of their claim against Gilbert, whose property and rights to property since that date have been encumbered by federal tax liens to the extent of the unpaid balance of the jeopardy assessments. Thus, not only did the government's action cause Gilbert to have taxable income in 1962, contrary to the steps being taken by Gilbert and Bruce which would have offset with a deduction the purported income realized by Gilbert from Bruce in 1962, but the government's jeopardy assessments through the years have proven to have been self-defeating.

It seems intolerable that the government's collection activities, apart from its audit functions, could so distort the income tax liability of any taxpayer. In the words of counsel to Bruce, the government's tax liens had Bruce "completely stymied" (Tr. 121; R. 45a). Obviously, Bruce was owed the full amount of the unauthorized withdrawals effected by Gilbert. But the result of the government's jeopardy assessments was that the government commenced a race with Bruce to obtain a secured claim against Gilbert. Bruce, having suffered unauthorized withdrawals caused by Gilbert, then suffered a further economic loss

when the government intervened and encumbered Gilbert's assets.

In an analogous situation, government action through service of a notice of levy was held to prevent the recognition of income. In Ray S. Robinson, 44 T.C. 20 (1965), the doctrine of constructive receipt was held to be inapplicable by the Tax Court because the corporation owing Robinson money, although willing to pay him, was prevented from making payment when the government made a jeopardy assessment and served the corporation with a notice of levy.*

It is respectfully submitted, therefore, that this Court should reverse the decision reached by the Court below and determine that Gilbert had no net embezzlement income for 1962 as determined by the statutory notice of deficiency.

*In C.B. 1970-2, xxi, the Internal Revenue Service in footnote 13 (p. xxiii) indicated that it acquiesced in result only on the issue relating to whether service of a notice of levy prevented Robinson's realization of income in the taxable year ending on the date of the fight, or in any event, in the 1957 calendar taxable year.

CONCLUSION

It is respectfully submitted that the decision of the Tax Court should be reversed and judgment entered in favor of the appellant.

Respectfully submitted,

CURTIS, MALLET-PREVOST,
COLT & MOSLE
Attorneys for Appellant
Office and P.O. address
100 Wall Street
New York, NY 10005

Of Counsel:

PETER E. FLEMING JR.
JOHN E. SPRIZZO
ROBERT D. WHORISKEY
JAMES M. BOYD

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

----- X

EDWARD M. GILBERT,

:

Appellant, : Docket No. 76-4170

-against-

:

CERTIFICATE OF
SERVICE BY MAIL

COMMISSIONER OF INTERNAL REVENUE,

:

Appellee. :

----- X

I, ROBERT D. WHORISKEY, Attorney for Appellant, hereby
certify that on the 22nd day of November 1976, service of
Appellant's printed main and reply briefs was made by mailing
three copies of each to Appellee by postpaid mail, addressed
as follows:

Mr. Gilbert E. Andrews
Chief, Appellate Section
United States Department of Justice
Washington, D.C. 20530
Att: F. Arnold Heller, Esq.

Robert D. Whoriskey
Robert D. Whoriskey